UBS House View

Monthly Letter

22 February 2018
Chief Investment Office GWM
Independent Investment Research

Relative calm
The worst of the volatility is likely past for now, extreme investor positioning has reset, and the VIX is close to long-run averages.

Strong backdrop
The economic backdrop remains broadly unchanged and positive. Growth is strong and corporate earnings growth is good. We do not believe that the recent sell-off presages a more prolonged decline in equity markets.

New dynamic
Hopes for higher growth may now have to compete with fears of higher inflation and interest rates. Abnormal calm is unlikely to return, and correlations between bonds and equities are likely to be less stable in this new phase.

Asset allocation
We still see opportunities in today's market and add a number of tactical asset allocation positions, but we are also preparing for the new environment by buying a put option on the S&P 500.

Mark Haefele
Chief Investment Officer
Global Wealth Management

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Entering choppier waters

Investors who kept calm, stayed invested, and rebalanced through the recent correction look set to be rewarded in a month that highlighted the difficulty, and potential costs, of trying to time the market. The worst week since 2016 was followed by the best week since 2015, and global equities are now just about 5% short of their all-time highs. Investors who sold out any more than three weeks too early and bought back any more than a week too late would still be worse off than a buy-and-hold investor.

Calmer market conditions, including the VIX volatility index returning to its long-run average, suggest that extreme investor positioning has reset, which should make markets more resilient. Importantly, the economic backdrop remains broadly unchanged, and positive. Growth is strong – services purchasing manager indices this month broke multi-year highs in both the US and China. Corporate earnings rose by around 15% in the fourth quarter, the fastest pace since 2011, and we project earnings growth in the low teens for global equities in 2018. And only limited moves in credit spreads suggest that the recent stock market sell-off should not harm the growth of the real economy.

We believe markets will continue to recover, see this as a good time for investors to look for opportunities, and add a number of new positions to our global tactical asset allocation. These include an overweight position in EM sovereign bonds in US dollars (USD) relative to high grade bonds, in US 10-year Treasuries relative to cash, in the euro relative to the USD, in the British pound relative to the Swiss franc, in the Japanese yen relative to the New Zealand dollar, and an underweight in Japanese 10-year government bonds relative to cash. Furthermore, we see this as a good time for all investors to review their portfolios and rebalance their equity holdings back to their strategic asset allocation targets.

UBS

We acknowledge that we are entering choppier waters.

But while we believe the worst of the volatility is likely behind us for now, we acknowledge that we are entering choppier waters, in which fears of higher inflation and interest rates could start to compete with, or even overwhelm, hopes for higher growth. So while we still see opportunities in today's market, we also prepare for the new environment by protecting part of our equity holdings by buying a 10% out-of-the-money put option on the S&P 500, and may add to this position in the months to come in order to diversify our strike prices.

We think it is prudent to potentially sacrifice some of our expected returns in order to boost portfolio stability.

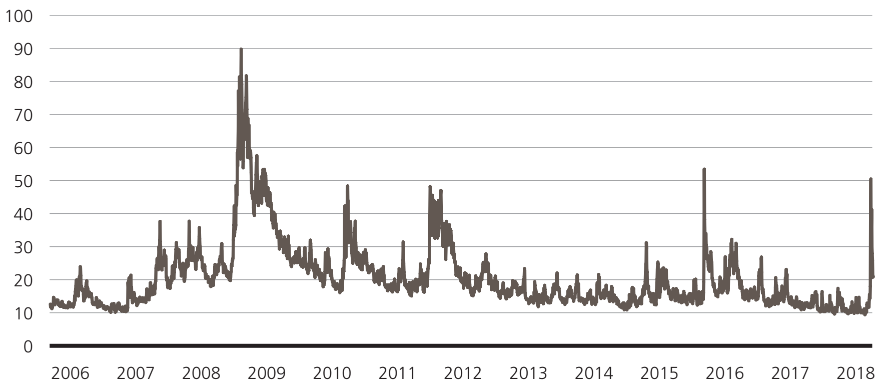
Should our base case of modestly higher inflation, measured Fed interest rate rises (one per quarter), and rising equity markets materialize, this position most likely will not be profitable. Yet we think it is prudent to potentially sacrifice some of our expected returns in order to boost portfolio stability if fears of higher interest rates continue to impact markets.

Charting the sell-off

After a run of 404 days without a greater than a 5% pullback, the longest stretch since the 1950s, markets were poorly positioned for a shock heading into February. Data showing faster-than-expected US wage growth led to higher government bond yields, and set in motion a chain of events that saw a significant unwind of investor positioning. Strategies targeting a specific level of volatility were forced to reduce equity holdings as measured volatility jumped, those taking short positions in the VIX volatility index were forced to cover as volatility rose, and many trend-following strategies reduced allocations to stocks in response to the price movements. US equities saw a peak-to-trough decline of 10.2% between 26 January and 8 February, and the VIX Index of implied volatility hit 50 (see Fig. 1), the highest level in more than two years.

Fig. 1: Volatility in equity markets spiked in February

CBOE VIX Index of S&P 500 implied volatility, intraday peaks



Source: Thomson Reuters, UBS WM CIO, as of 19 February 2018

Excess equity long positioning has now largely unwound, and buyers are re-entering the market. We estimate that equity long positions among trend-following hedge funds (CTAs) were in the 99th percentile since 2008 prior to the sell-off, but are now down to the 28th percentile. Equity mutual funds saw their largest outflow on record in the week of the sell-off (USD 30.6 billion). And the end of earnings season is enabling corporate bidders to re-enter the market – buybacks are now at a year-to-date record of USD 170.8bn.

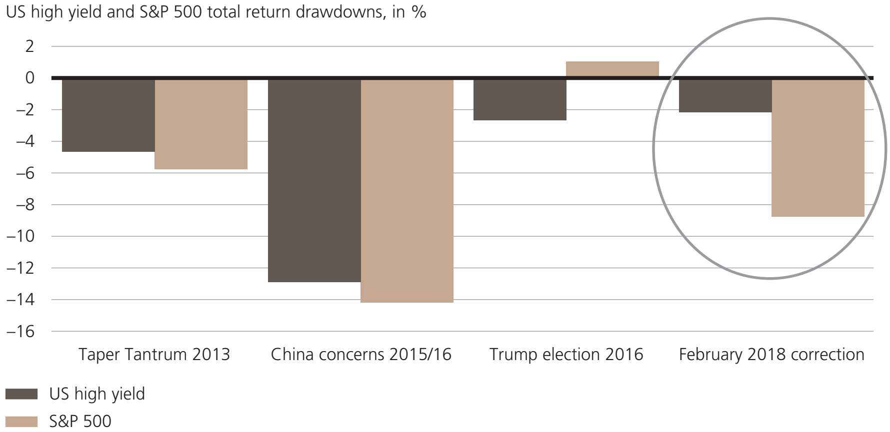
Negative wealth effects from the recent sell-off appear to be limited.

Negative wealth effects appear to be limited: the University of Michigan consumer confidence index actually rose in February, with the survey suggesting that positive perceptions of tax reform more than offset lower stock prices. Negative references to stock prices were spontaneously cited by just 6% of consumers in the latest survey, whereas favorable references to government policies were cited by 35% – the highest level in more than 50 years.

It is also reassuring that the turbulence was relatively contained to equity markets. The JPMorgan FX Volatility Index rose only slightly, climbing from 8.4 on 5 February to just 9.1 on 9 February – still below its 25-year median of 10.2. Equally, the MOVE Index of bond volatility hit a high of 71 on 9 February, well below its 25-year median of 94. There were no indicators of stress in interbank markets – the TED spread, which measures the premium demanded for assuming bank credit risk, actually fell during the stock correction. And credit spreads did not widen materially. The cost of insuring five-year USD investment grade bonds against default climbed from around 48bps a year to a peak of 60bps during the sell-off – well below the average of 78bps since 2011. And USD high yield spreads widened by just 46bps, less than half of what might ordinarily be expected given the size of the equity market sell-off (see Fig. 2).

Fig. 2: Drawdown in credit was less than in previous market shocks

US high yield and S&P 500 total return drawdowns, in %



Source: Bloomberg L.P., UBS WM CIO, as of 19 February 2018

Seeking opportunities

We see the recent drop as an opportunity for investors to add to positions.

With excess positioning largely unwound, limited evidence of an impact on growth, and contagion into other asset classes low, we see the recent drop as an opportunity for investors to add to positions. We make a number of adjustments to our tactical asset allocation to take advantage:

We are now overweight EM sovereign bonds in USD versus high grade bonds.

Overweight EM sovereign bonds in USD vs. high grade bonds. Spreads have widened to 284bps, from about 260bps prior to the sell-off, in spite of little change to the positive backdrop for EM. Purchasing managers' indices are trending up, inflation is mostly low and stable, and overall credit quality is improving, with just 14% of issuers seeing deteriorating credit ratings.

We are now overweight on the euro versus the US dollar.

Overweight euro vs. US dollar. The greenback quickly resumed its downward trend after a brief rally amid the sell-off, and we expect further downside to come, relative to the euro. Growing US fiscal and current account deficits will need financing, and that could require a cheaper USD. US net liabilities are now at a record 40% of GDP, and to help stabilize the position, we estimate a 6–10%

(broad) depreciation is needed over the medium term. The USD also remains overvalued against the euro on a purchasing power parity basis, which we estimate at 1.28.

We are now overweight on the British pound versus the Swiss franc.

Overweight British pound vs. Swiss franc. The Swiss franc rallied versus the British pound as investors sought safety in the franc. From here, we think that focus is likely to return to the improving UK economy. GDP growth has accelerated for each of the past four quarters, and the Bank of England has signaled a greater urgency to increase interest rates. Brexit remains a risk, but business uncertainty appears to be falling. Meanwhile, demand for safe-haven Swiss francs is likely to fall in a still-robust global economic environment.

We are now overweight on the Japanese yen versus the New Zealand dollar.

Overweight Japanese yen vs. New Zealand dollar. We see upside potential for the Japanese yen given the currency's undervaluation at a time when the country's growth is strong and inflation is increasing. The New Zealand dollar, meanwhile, could see outflows if interest rates rise in the US or elsewhere. The risk for NZD is heightened by the country's weakening economic situation at present – we expect New Zealand to see a larger economic slowdown in 2018 than any other country in the G10.

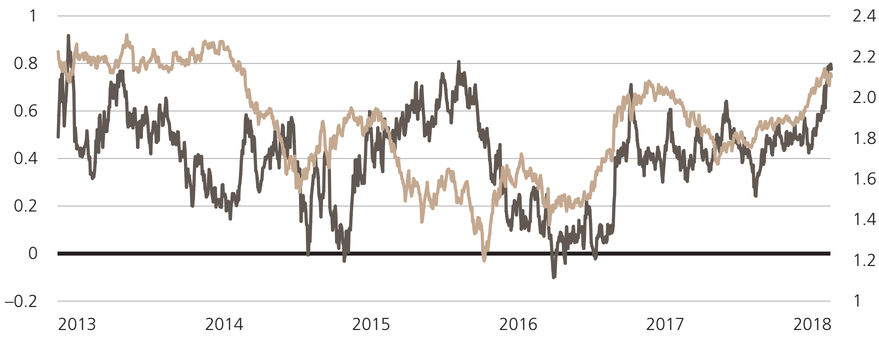
We are now overweight 10-year US Treasuries.

Overweight 10-year US Treasuries vs. cash. After an 80bps increase in the past five months, we believe the bulk of the increase in US 10-year yields is done, and we see this as an attractive entry point to buy Treasuries. Real yields are at the top of their trading range since 2013, and inflation breakevens are close to the Fed's target of 2% (see Fig. 3). This means that to see higher yields, the market would need to revise up its view of long-term growth, change its opinion of the Fed's policy approach, start to demand much greater compensation for holding longer-term assets due to elevated uncertainty, or expect the Fed to sustainably overshoot its inflation target.

Although negative perceptions of the rising US fiscal deficit are a risk that could increase term premiums, unchanged long-term productivity trends, ongoing demand for fixed income assets from institutional buyers like banks and pension funds, and continuity in Fed leadership, mean that we believe further increases in yields would likely not be fundamentally justified. With carry and roll down returns of around 1.6% in the next year, yields would need to rise by about 20bps for this position to be unprofitable.

Fig. 3: Inflation expectations and real yields have been near the top of their recent range

US 10-year real yields and US 10-year breakevens, in %



Source: Bloomberg L.P., UBS WM CIO, as of 19 February 2018

We are now underweight 10-year Japanese government bonds.

Underweight 10-year Japanese government bonds (JGBs) vs. cash. Since late 2016, the Bank of Japan (BoJ) has operated a "yield curve control" policy, effectively capping the 10-year yield, in its attempt to boost inflation. But core inflation is now set to accelerate substantially from 0.9% year-over-year today, to 1.3% by the end of 2018, and 2.1% by the end of 2019. Since the BoJ judges monetary policy by the real rate, not the nominal rate, it needs to raise its yield cap just to prevent inflation from making monetary policy even looser. We expect the BoJ to lift its cap by around 25bps by year end. Although the prospective increase in yields is small, we see limited potential downside to the trade: the BoJ is highly unlikely to want to cut rates against the current economic backdrop, and the cost of shorting JGBs is very low – we estimate the total cost of carry and roll down at just six basis points per annum.

We close our overweight position in EM local currency bonds relative to high grade bonds.

We close our overweight position in EM local currency bonds relative to high grade bonds. The position has performed well since inception, up more than 8%. At this point the return outlook is less appealing. After a 4% rally, there is less near-term upside for EM FX, and perhaps more importantly, limited potential for further compression in spreads versus USD high grade bonds, with spreads the lowest since 2008. We prefer to take EM fixed income exposure through our new position in EM sovereign bonds in USD.

We close our overweight position in SEKNOK.

We close our overweight position in SEKNOK. Swedish inflation has failed to overshoot the Riksbank's 2% target in recent months, and we expect inflation to remain soft, making it more difficult for the central bank to hike rates. Meanwhile, Norwegian economic momentum has been bolstered by steadier oil prices, and the country's January manufacturing PMI came in at 59, signaling strong expansion. As a result, it is unlikely that this position would offer substantial upside in coming months.

We remain overweight global equities, EM equities, and select currencies. We also remain overweight Eurozone equities and the Canadian dollar.

Existing positions. We remain overweight global equities. We expect earnings growth in the low teens for global equities, and the recent market decline has left global markets on just 17.7x P/E, below the 30-year average of 18.3x. We hold overweight positions in EM equities and select currencies (the Brazilian real, Indian rupee, Russian ruble, and Turkish lira). The recent economic environment of strong global growth, rising commodity prices, yet a falling US dollar, is particularly favorable for EM, and it was notable that EM equities outperformed US equities through the recent correction. Elsewhere, we remain overweight Eurozone equities relative to UK equities, as we expect more robust earnings growth in the Eurozone to drive relative outperformance, while sterling's recovery could weigh on UK earnings (with 70% of FTSE 100 revenues coming from overseas), and we overweight the Canadian dollar relative to the US dollar, as we believe the market is underpricing the Bank of Canada's rate hiking path.

Managing new market dynamics

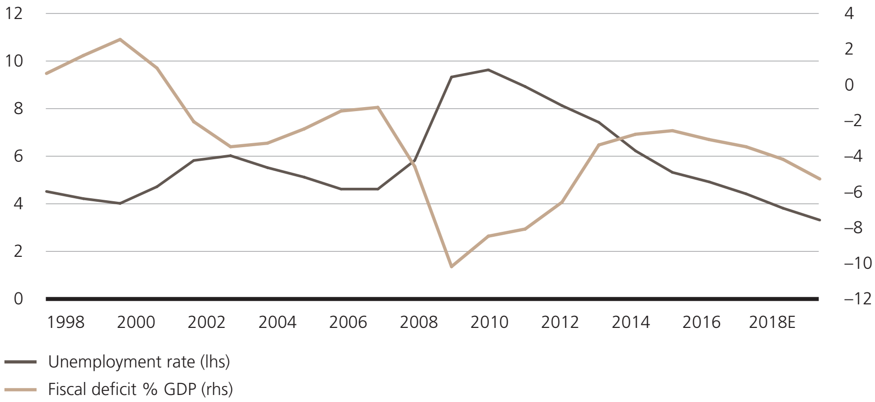
We do not believe that the recent sell-off presages a period of slower economic growth, nor a more prolonged decline in equity markets. In a period of robust global earnings growth, we are conscious of the potential costs of trying to time the market, exemplified in this month's rapid rebound after the sell-off. Our tactical asset allocation remains pro-risk.

However, the US will soon be running USD 1trn (and growing) annual fiscal deficits when unemployment is just 4.1% (see Fig. 4). So there is a non-negligible possibility that inflation rises more quickly, and the Fed turns more hawkish than markets currently expect. The "goldilocks" environment of low inflation, low interest rates, and ample central bank liquidity has clearly supported asset values, and investors are therefore likely to be more sensitive to signs that it might be

ending. So even if the events of the past month do not mark a turning point, they could suggest the beginning of a new phase in the market cycle, one in which fears of higher interest rates begin to compete with, or even outweigh, hopes for higher growth.

Fig. 4: The deficit is rising even when unemployment is trending lower

US unemployment rate in % and general government budget balance as % of GDP



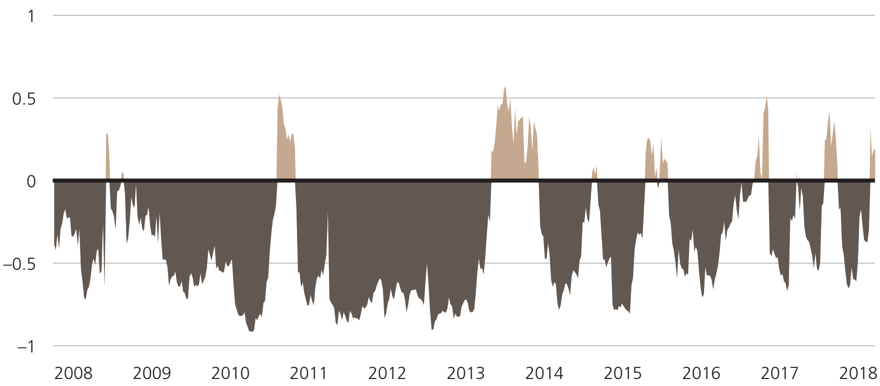
Source: UBS, as of 19 February 2018

In this new phase, correlations between bonds and equities are likely to be less stable.

In this new phase, correlations between bonds and equities are likely to be less stable (see Fig. 5). We saw an example of this in the recent sell-off: usually if equities fall, one would expect high grade bonds to rally; this time they lost value.

Fig. 5: Correlations between equities and bond prices are back in positive territory

13-week rolling correlation between S&P 500 and US 10-year Treasuries



Source: Bloomberg L.P., UBS WM CIO, as of 19 February 2018

In a market with good fundamentals but rising uncertainty, we need to be wary of the potential risks of mistiming the market, and also look beyond traditional bond-equity diversification to protect portfolios. So while we keep a pro-risk stance overall, and do not cut back on our existing positions, we buy a 10% out-of-the-money put option on the S&P 500, which should help stabilize portfolios during periods when markets shift their focus away from higher growth, and toward fears of higher inflation and/or tighter policy. We would also expect that our overweight position in the Japanese yen relative to the New Zealand dollar

would perform well in the event of a market downturn – the yen has traditionally held a role as a safe haven in times of market stress, and it proved this in the recent sell-off, appreciating by 2.4% on a trade-weighted basis.

In order to diversify our strike prices, reduce exposure to time decay, and potentially reduce the cost of buying protection (option prices typically take a few months after a sell-off to normalize), we initially only buy protection sufficient to cover 3% of an overall portfolio, but may increase this in the months to come. We have chosen to implement the position on the S&P 500, not because we have a particularly negative view on the US market, but because the S&P 500 option market is the world's most liquid, and the index is a close proxy for global equities (US equities represent 52% of global equities).

Small potatoes
William Dudley, President of the Federal Reserve Bank of New York, described the drop in the stock market as "small potatoes," suggesting the Fed is unconcerned about the rise in volatility. With the rally from the lows, those potatoes got even smaller. But we're conscious that even the smallest potatoes can be hard to digest if they're not prepared right. So while we're looking for opportunities after the sell-off, we're also readying ourselves for more turbulent markets ahead.

Gold and bitcoin as "safe havens?"
Gold. We do not advise holding a long-term allocation to gold in our strategic asset allocations because we believe that, over the long-term, its return potential does not compensate for its volatility. But in a world of anxiety about high and rising US fiscal deficits, gold could have some role as an insurance asset, particularly if the US dollar and US Treasuries stop functioning in their traditional roles as safe havens. Gold prices are ordinarily negatively correlated with US real yields, but in recent weeks they have moved up together, leading us to think they may not be rising *in spite of* rising US real yields, but rather *because of* rising US real yields, with both moves reflecting worries over higher US inflation and fiscal deficits. It is also notable to see that the correlation between gold and two-year US inflation breakevens is at its highest level in more than two years.

Bitcoin. Although the number of questions we have been getting about bitcoin has reduced since the start of the year (the number of queries fluctuates almost 1-1 with bitcoin's price), I know some were considering its role as a "safe haven," given its detachment from the financial system. But in our view, it cannot be considered any kind of "safe haven." Its volatility is more than 10x that of equities, and its correlation is close to zero but not negative, meaning that it cannot be expected to rally when markets fall.

Mark Haefele
Chief Investment Officer
Global Wealth Management

linkedin.com/in/markhaefele

twitter.com/UBS_CIO

UBS Investor Forum Insights

At this month's Investor Forum, participants discussed the outlook for risk assets:

- Most participants shared a positive outlook on equities versus bonds. Within equities, they shared the view that the strong economic backdrop should support emerging markets at this stage of the cycle.
- Participants broadly agreed that this year should be more volatile, which is not unusual in the latter stages of a bull market.
- There was a broad consensus that inflation is a rising concern.

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